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Arizona Corporation Commission

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California Public Utilities Commission
505 Van Ness Avenue
San Francisco 94102

Re: Comments of Arizona Public Service Company on Proposed
Policy Decision Adopting a Preferred Industry Structure, Docket
Nos. R.94-04-031 and I.94-04-032

Please find enclosed four copies of the comments of Arizona Public Service Company in response to the Commission's request for comments in the referenced dockets.

A separate copy is being furnished to the Chief ALJ Lynn Carew and to all those whose addresses are included on the service list.

Sincerely,

Thomas E. Parrish

Enclosure

cc: Arizona Corporation Commission w/enclosure

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

Order Instituting Rulemaking on the Commission's
Proposed Policies Governing Restructuring
California's Electric Services Industry and
Reforming Regulation.

R.94-04-031
(Filed April 20, 1994)

Order Instituting Rulemaking on the Commission's
Proposed Policies Governing Restructuring
California's Electric Services Industry and
Reforming Regulation.

I.94-04-032
(Filed April 20, 1994)

**COMMENTS OF ARIZONA PUBLIC SERVICE COMPANY
ON PROPOSED POLICY DECISION
ADOPTING A PREFERRED INDUSTRY STRUCTURE**

Introduction

Arizona Public Service Company ("APS") appreciates the opportunity to comment on the California Public Utility Commission's ("the Commission") Proposed Policy Decision Adopting a Preferred Industry Structure ("Poolco Proposal"). APS is a public service corporation organized under the law of the State of Arizona and is engaged in the business of generating, transmitting, distributing, and selling electricity at retail in all or part of eleven of Arizona's fifteen counties. APS serves numerous wholesale customers with power, and provides various transmission services to utilities, municipalities, Federal power marketing agencies, agricultural, irrigation and drainage districts, and Indian power authorities within the State of Arizona. APS owns and operates 4,195 miles of transmission lines with capacities ranging from 69kV (47% of the total) through 500kV.

APS' generating facilities have an accredited capacity of 4,022 mW, including 1,108 mW of nuclear, 1,687 mW of coal, 1,222 mW of gas or oil, and 4.2 mW of hydro. APS jointly owns several plants with California utilities.

APS has been actively participating in Arizona's open Docket on Competition. It has followed California with great interest as well. APS committed to filing a Report with the Arizona Corporation Commission in the near future which outlines APS' view of the best means to transition to competition. As part of that Report, APS will further explain its position on restructuring of the wholesale bulk power market. APS will comment at this time on certain general principles which APS believes should be changed to make the Poolco Proposal acceptable to more participants. APS is aware that the FERC is requiring that market power issues be addressed prior to presenting the Poolco Proposal to FERC for approval. In order to achieve greater participation, the Poolco Proposal should be made voluntary and more flexible. APS' reasoning is as follows.

Comments

There are certain principles which the CPUC should consider. The goal of restructuring the wholesale electric power market is not merely competition, but *efficient* competition. Achieving efficient competition requires:

1. Coordination of dispatch to achieve maximum productive efficiency
2. Comparable and non-discriminatory open transmission access
3. An active wholesale market with many competitors having access to the **relevant** marketplace
4. Unbundled and efficiently priced ancillary services with non-discriminatory charges and equal responsibility for payment by all participants
5. Regional coordination of transmission planning
6. Transparent spot prices available to all participants for sales and purchases of energy and that provide information to generators and customers for evaluating potential power contracts
7. Recovery of all previously recognized costs and investments that otherwise could become stranded by changes in pricing and access rules.

In achieving the transition to an efficiently competitive market, APS proposes building upon the existing wholesale market. This includes both the (mainly regulated) bulk power contract market and the (mostly unregulated) coordination market. The region's utilities have extensive

experience with competition in the coordination market and its institutions already are in place. The existing coordination market is highly competitive and achieves most (though not all) of the dispatch efficiencies that could be achieved.

While building on these institutions and experiences, we are aware that improvements must be made before competition can achieve maximum benefits. We see the following areas of deficiency to be remedied:

- ◆ The absence of formal dispatch coordination means that not all operational efficiencies are gained. We believe additional energy savings can be realized through some form of coordinated dispatch.
- ◆ Incomplete transmission access, insufficient unbundling, and less than full comparability in pricing and access also impedes competition. These defects will be significantly reduced by FERC at the conclusion of the current open access NOPR process.
- ◆ The right to market access has been difficult for NUGs, marketers and brokers, and in some instances, utilities.

An examination of the experiences of other utilities and statements of other interested parties suggests that the Pooelo Proposal should be changed to be voluntary and more flexible. Experience overseas, particularly in the United Kingdom where a competitive wholesale market has existed for five years, provides many insights into both practices to be adopted and avoided. The debate in the U.S. over the past 3 years, at FERC, and in the various state investigations, reveals a wide range of proposals and concepts that have been debated extensively.

The Poolco Proposal appears to have been derived in many respects from the United Kingdom pool model. Operation of the U.K. pool has been examined closely and a number of criticisms of it have been made. Many of these criticisms are due to the insufficiently competitive structure of generation, with only two generating companies setting the pool price nearly all of the time. Such a structure is inconsistent with any competitive generation market and would result in the same abuses in almost any structure. With two dominant generation owners in California, such a closed pool may suffer similarly. However, some defects of the model are not due to the market dominance of two dominant generators and should be avoided. The best features of the pool concept should be preserved while avoiding many of its defects. The defects to avoid are:

- ◆ *The involuntary or mandatory nature of participation in the pool and its single pricing mechanism.* Many see the mandatory pool as an unnecessary monopoly. It is feared that the pool will be a strait-jacket that limits the benefits that competition might bring in terms of creative pricing that provides choice to contracting parties. Further, if pool pricing rules are imperfect or unnecessarily burdensome, they may create inefficiencies

³The term "contract for differences" arises from the fact that all generation must be sold to and brought from the pool. Any contract must take this transaction into account. For example, a firm price contract requires that the seller compensate the buyer when the pool price is above the contract price, while the buyer pays the seller the difference between the contract price and pool price when the latter is lower.

that cannot be avoided by generators and retailers who otherwise could engage in more efficient transactions. There also is no cost discipline on pool operation that otherwise would be available from parties choosing not to participate. (For example, if aggregators can procure better generation prices than can be obtained through the pool by a local distribution company, then the real competition will not come from the pool clearing price.)

- ◆ *The risk of regulatory interference.* The mandatory nature of a pool invites more regulation. It could become a regulated entity that can be "tinkered with." If more alternatives were present, e.g. bilateral contracts, self-nomination, spot pool, and made available to buyers and sellers and all scheduled through an independent transmission operator who acts more like a broker as an agent of the parties, this temptation to add another layer of regulation would not be present.
- ◆ *Constraints on contracting freedom.* A U.K.-style pool permits only "contracts for differences." ³Many see this as inhibiting a variety of contracts that would evolve naturally in a competitive market.
- ◆ *Pricing complexity.* Less experienced participants in the U.K. pool complain of complex bidding and price formation rules that advantage experienced participants and that have been "gamed" by some generators. In turn, this gaming is a main reason why the U.K. regulator has intervened to re-regulate generation pricing with increasing frequency.
- ◆ *Delay in implementation.* Imposition of a mandatory poolco that governs the pricing of all the wholesale market will require the participation of all affected parties in creating its rules. Many participants will have diametrically opposing interests. Pool rules will be fought over at length and, most likely, litigated. Regulators likely will be dragged into the process and formal proceedings will delay progress toward a competitive market still further. If the central dispatch that accompanies poolco also requires creation of operational institutions that wholly displace existing dispatch centers, further delay is likely. An evolutionary next step, rather than a revolutionary next step, will appeal to a broader group of market participants.

The common theme of these criticisms is the involuntary nature of the Poolco Proposal. APS believes most criticisms can be circumvented by making participation in any type of pool voluntary. Not only should utilities be free to join or not, they should be able to contract for power fully outside of the pool, if desired.

Conclusions

APS is flexible concerning the specifics of institutions and rules supporting the establishment of a more competitive wholesale market, provided the above stated transition principles and lessons learned regarding efficient competition are followed. Our investigation to date suggests that:

- ◆ Participation should be voluntary, and direct contracts outside the market mechanism permitted;
- ◆ A transparent spot market is required;
- ◆ Coordination of transmission and generation scheduling and communication of spot-market prices likely will require an operating agent who would not be affiliated with any buyer or seller in the market;
- ◆ If such an agent is created, there may be efficiency benefits if it takes on direct responsibility for transmission and generation scheduling in accordance with bids and/or instructions by owners (rather than merely coordinating the actions of existing dispatch and area control functions of member utilities); and
- ◆ Transaction savings may be gained if such an agent also takes over the real-time communication of transmission capacity availability functions of member utilities that are required by the FERC NOPR and, perhaps, competitive procurement of the ancillary services that the NOPR requires member utilities to make available.

APS believes that the market area covered by a wholesale market should eventually be as large and comprehensive as possible. This facilitates achievement of maximum economies of coordinated operation and reduces, even eliminates, the market dominance concerns that otherwise might require continued regulation of pricing.

All generators in this region should be entitled to join the market, as should all wholesale customers and power brokers. Participation must be voluntary. Existing contracts must be grandfathered. Integrated utilities should be members by virtue of both generating and purchasing functions. Criteria for membership and/or participation should include agreement to abide by market rules (those required by the Regional Transmission Groups, such as WRTA and SWRTA, the National Electric Reliability Council FERC, and those necessary for the functioning of a competitive spot market) and the demonstration (on the part of buyers) of credit worthiness.

In order to fully achieve the advantages of market enlargement and economy of operation, it is very useful that all generators and transmission owners in the geographic area participate in the market. We can see no reason why any generator or transmission owner would choose not to participate in a voluntary pool where even more marketing opportunities would be created.

Closing

Thank you for the opportunity to comment on the Commission's Poolco Proposal. As usual, the Commission's inquiry has fostered much thought and discussion within the electric industry, all of which will hopefully lead to a more competitive, more efficient market for electricity, and eventually, market choices for electric users.

Dated this 18TH day of July 1995.

ARIZONA PUBLIC SERVICE COMPANY

By Jack E. Davis
Jack E. Davis, Vice President
Generation and Transmission